Can rating agencies look through the cycle?

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Abstract

Rating agencies claim to look through the cycle when assigning corporate credit ratings, which entails that they are able to separate trend components of default risk from transitory ones. To test whether agencies possess this competence, I take market-based estimates of one-year default probabilities of corporate bond issuers and estimate their long-run trend using the Hodrick-Prescott filter, local regression, or centered moving averages. I find that ratings help identify the current split into trend and cycle. Their stability is similar to the one of hypothetical ratings based on trends. Since the examined trends are forward-looking, agency ratings exhibit important characteristics one would expect from ratings that see through the cycle.

Key words: credit ratings, through-the-cycle, Hodrick-Prescott filter.

JEL classification: G20, G33

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1 Introduction

A key characteristic of corporate credit ratings[1] produced by the major rating agencies is that they are meant to look through the cycle. The agencies' aim is to base rating assignments on the expected long-term credit quality, and not respond to transitory fluctuations in credit quality.[2] In justification of this approach, agencies cite investor preferences for stable ratings (Fons, 2001). Such preferences can arise, for example, from rating-based portfolio governance rules which lead to high transaction cost if ratings change frequently.

As stressed by the agencies themselves, looking through the cycle is difficult.[3] This seems to be one of the reasons banks usually do not employ the through-the-cycle approach when assigning internal credit ratings for their borrowers (Treacy and Carey, 1998). Academic research, too, is beset by complications in detecting long-term trends. It is difficult to identify and disentangle transitory and permanent components of stock prices, for example, even when fifty years or more of data are available; and the evolution of the literature shows that the choice of appropriate statistical techniques is not obvious.[4]

The ability to rate through the cycle thus seems to be a core competence of rating agencies, even though there has till now been no empirical study which examines whether agencies actually possess this competence. The lack of research is even more surprising since a devil's advocate might contend that rating through the cycle is nothing more than a marketing story contrived to cover a low-cost policy of reviewing ratings only infrequently. By classifying new information as transitory, agencies could avert frequent criticism for reacting too slowly to new information. The view that major rating agencies are too slow to change their ratings is held by a number of investors (cf. Baker and Mansi, 2002), academics (e.g. Daníellson et al., 2001), and competitors (e.g. Egan and Jones, 2002).

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[1] Note that this paper deals with corporate credit ratings. Structured finance ratings, which feature prominently in the discussion of the subprime crisis, are assigned by different rating units based on a different rating approach. An assessment of rating quality should therefore be conducted separately for the two types of ratings. Of course, it can be useful to draw parallels between the two rating types, which I will do in the conclusion.

[2] Cf. Basel Committee on Banking Supervision (2000), Cantor (2001), and Standard and Poor's (2003).

[3] Cf. Standard and Poor's (2003), pp.41-43.

[4] See, e.g. Campbell, Lo and MacKinlay (1997), pp. 78-80.

In this paper, I document that agency ratings exhibit key characteristics one would expect from through-the-cycle ratings. Before detailing this statement, I clarify the terminology because different wordings and usages can give rise to confusion. The following wordings are equivalent for the purpose of this paper:

Time series	=	trend component	+	cycle component
Time series	=	permanent component	+	transitory component

Another word for trend would be permanent component; the analogous term for cycle is transitory. An example is a series composed of a random walk plus an autoregressive process of order 1, AR(1); in this example, the stochastic trend of the random walk constitutes the trend of the aggregate series. How does the distinction between systematic and non-systematic risk components relate to this? Cycles can be both systematic and non-systematic, the same holds for trends.[5] One might first think of macroeconomic or aggregate stock market cycles. However, the major part of a typical firm's risk is non-systematic (see Campbell et al., 2001); consistent with this finding, the default risk series used in this paper are largely driven by non-systematic cycles and trends, too. I therefore refrain from using the distinction in the estimation and analysis of the series.

I start the empirical analysis with a robust, model-free analysis. I examine whether ratings are useful for predicting changes in EDFs, which are market-based estimates of one-year default probabilities. The results - ratings predict changes in EDFs over a horizon of up to 3 years – already establish the forward-looking ability of ratings. Then, I set out to provide a more direct test of the agencies' ability to look through the cycle. The rating agencies do not give a precise, formal definition of what they aim at when looking through the cycle. Based on the academic literature (cf. Löffler, 2004), a characterization that captures its essence is to say

[5] Let me give an example for each combination: a change in the cyclical component of a firm's default risk would be systematic if it is associated with aggregate changes in profitability over the business cycle; a change in the trend component would be systematic if it is part of a permanent, market-wide increase in leverage. Non-systematic cycles can arise if firms respond to firm-specific shocks by rebalancing their capital structure (cf. Graham and Harvey, 2001, Fama and French, 2002, Flannery and Rangan, 2006, and Leary and Roberts, 2005). If a firm decides to increase its leverage permanently without the average firm doing this at the same time, there would be a non-systematic change in the firm's trend component.

that ratings are based on the trend component of a firm's short-term default risk.[6]

The research strategy is as follows: I take EDFs and estimate their trend component using the Hodrick-Prescott filter (Hodrick and Prescott, 1997), centered moving averages, or local regressions (Cleveland, 1979). These three filter methods use both past and future data to identify the trend at a given date, thus seeing through the cycle. Irrespectively of the filtering method, I find that agency ratings help predict the current state of the EDF trend. Also, the low variability of ratings is largely in line with the low variability of long-term trends. Summing up, ratings are not crystal ball but they exhibit important characteristics one would expect from ratings that see through the cycle.

The remainder of this paper is structured as follows. The relevant literature is summarized in section 2. After a description of the data in section 3, section 4 examines whether ratings predict future changes in EDFs. Section 5 analyses the relationship between trends, cycles and ratings from different perspectives. Section 6 concludes.

2 Relevant literature

Conceptual aspects of the through the cycle-methodology have been explored by Carey and Hrycay (2001) and Löffler (2004). Simulations in Löffler already suggest that key empirical characteristics of ratings like their low variability *could* stem from a through-the-cycle approach. In a similar vein, Altman and Rijken (2004) quantify the *potential* effects of a through-the-cycle policy by benchmarking it against quantitative scoring models. The present paper documents the empirical relevance and validity of the possibility results derived by Löffler and Altman and Rijken.

There is evidence that the agencies' default predictive power increases with an expanding time horizon (Altman and Rijken, 2006, Löffler, 2007). This could reflect an ability to look through the cycle, but it could also be due to simple, backward-looking smoothing. Similarly, findings that rating actions are procyclical (Nickell, Perraudin and Varotto, 2000, Bangia et

[6] One could argue that this statement is incomplete because it misses the stress scenario approach described in the literature. I discuss this aspect in section 5.2.

al., 2002, Amato and Furfine, 2004) do not establish that agencies do not look or rate through the cycle. Business cycle fluctuations that coincide with permanent changes in credit quality are one reason why we could see such pattern.[7] An example would be a recession that is sparked by increased international competition, which can permanently lower the profit margins of some firms even after the economy has adjusted to it and overcome the recession.

There is a wide literature on detrending time series. Several contributions indicate problems with the Hodrick-Prescott filter, which is widely used in empirical macroeconomics. The studies document that detrending results are sensitive to the choice of filter, and that the Hodrick-Prescott filter can identify spurious trends (Harvey and Jaeger 1993, King and Rebelo, 1993, and Cogley and Nasion, 1995). Ehlgen (1998) and Pedersen (2001) give new support to the use of the Hodrick-Prescott filter by showing that even optimal (in the mean-squared error sense) filters can give rise to distortions, and that the Hodrick-Prescott filter is less distorting than other filters.

For the purpose of the present paper, the issue of statistically spurious trends does not seem critical, for the following reasons: (i) the reported results are robust to the use of different filter techniques; (ii) statistical tests typically have low power in identifying long-term cyclical patterns, while rating agencies might have used information beyond the time series data examined by the statistician. Rating agencies could be able to to exploit predictability in circumstances where statistical tests do not find significant cyclical patterns and thus classify filtered trends as spurious. In such a situation, forward-looking trends also serve their purpose for the present paper. A forward-looking trend that is classified as spurious will nevertheless have the property that the difference between the trend and the current value of the series predicts subsequent movements of the series. In other words, it is not evident that a rating that looks through a possibly spurious cycle is less valuable to rating users than a rating that is assigned for a firm whose cycle withstands statistical tests.

Kisgen (2006) finds that firms' capital structure decisions are affected by their desire to meet

[7] "In any case, purely cyclical factors are difficult to differentiate from coincident secular changes in industry fundamentals, such as the emergence of new competitors, changes in technology, or shifts in customer preferences" (Standard and Poor's, 2003, p. 42).

rating targets. This may raise concerns about the interpretation of the results from the present paper. Firms that change their capital structure to maintain a rating tend to confirm the current rating assessment. If ratings are found to predict future default probabilities, some part should perhaps be credited to this self-fulfilling prophecy character of ratings rather than to a genuine forecasting ability. A look at the empirical findings indicates that this part is not likely to dominate. In Kisgen (2006, Table IX), ratings and contemporaneous control variables explain less than 3% of the variance of one-year capital structure changes. If there were a 100% correlation between capital structure changes and default probabilities, the fit from those regressions could thus explain 3% of the variation in default probabilities. In the present paper (Table 2), however, ratings and control variables explain 7% of the variance of one-year changes in default probabilities. The part that can be attributed to self-fulfilling prophecies is likely to be significantly less than 3/7 because (i) the correlation between capital structure and default risk is not 100%; (ii) Kisgen uses contemporaneous control variables which I do not; (iii) some of the capital structure changes explained in the Kisgen regressions are motivated by a desire to change the current rating, not to maintain it.

3 Data

The analyses use monthly data on Moody's long-term senior ratings and Moody's KMV Expected Default Frequencies (EDFs) for US and non-US corporate bond issuers. Issuers contained in the data base are made up of the intersection of issuers which have a Moody's rating and traded equity. EDFs estimate a firm's one-year probability of default based on the option-theoretic approach of Merton (1974).[8] EDFs have been shown to provide powerful default risk forecasts relative to ratings and accounting-based measures of default risk.[9] They thus appear to provide a good proxy for the true short-term default risk.

The data covers the period from 1980 to 2005, but because Moody's refined its rating system

[8] See Kealhofer (2003).

[9] See Bohn, Arora and Korablev (2005). Campbell, Hilscher and Szilagyi (2008) and Bharath and Shumway (2008) conclude that the Merton model underlying the EDF is inferior to reduced form hazard models. However, they do not test EDFs produced by Moody's KMV but standard Merton model implementations. The latter have been shown to underperform the former by Bohn, Arora and Korablev (2005).

in 1982, I start the regression analyses in December 1982. Ratings enter the analysis as cardinal numbers from 1 (Aaa) to 21 (C). Empirical default rates rise exponentially with deteriorating grades, which is why I use logarithmic EDFs for the entire analysis. (When mentioning specific EDF values, the simple probabilities will nevertheless be used.)

The simple conversion of ratings to numbers from 1 to 21 has been found to work well in a rating prediction model used by Kisgen (2006), and so it does here. Table 1 shows descriptive statistics on EDFs and ratings. Skewness and kurtosis of the two variables are fairly close. The table also presents adjusted R^2s from regressions in which log EDFs are explained by (i) the simple rating conversion, (ii) a fifth order polynomial in the simple rating conversion, (iii) a conversion of ratings to default probabilities (specifically, I take Moody's idealized default probabilities from Yoshizawa, 2003). The default probability conversion leads to a worse fit than the simple numerical representation. Allowing non-linearities in the latter does not greatly improve the fit. With a fifth-order polynomial, the R^2 rises only from 44.4% to 46.6%, and the predicted fit is non-monotonic for high EDF levels, which indicates overfitting.

4 Do rating agencies predict future changes in default probabilities?

Consider a process x_{t+1} that is made up of a random walk $z_{t+1} = z_t + v_{t+1}$ plus an AR(1) that follows $y_{t+1}=\rho y_t + u_{t+1}$, $0 < \rho < 1$. With such a process, knowing the current z_t and x_t helps explain future changes in x:

$$\begin{aligned} x_{t+1} - x_t &= y_{t+1} + z_{t+1} - y_t - z_t = y_{t+1} - y_t + z_{t+1} - z_t = y_{t+1} - y_t + v_{t+1} \\ &= \rho y_t - y_t + u_{t+1} + v_{t+1} \\ &= (\rho - 1) y_t + \varepsilon_{t+1} = (\rho - 1)(x_t - z_t) + \varepsilon_{t+1} \\ &= (\rho - 1) x_t - (\rho - 1) z_t + \varepsilon_{t+1} \end{aligned} \tag{1}$$

with $\varepsilon_{t+1} = u_{t+1} + v_{t+1}$. In the regression $x_{t+1} - x_t = \gamma_0 + \gamma_1 x_t + \gamma_2 z_t + \varepsilon_{t+1}$, we would therefore have $\gamma_1 = -\gamma_2 = (\rho - 1)$. If the z_t is only observed with error, the estimated γ coefficients will be biased away from $(\rho - 1)$, but the x_t and z_t will still explain future changes in x. The example illustrates that the ability to look through the cycle—i.e. the ability to identify the z — implies the ability to forecast the original series. This motivates a first, model-free test of whether rating agencies can look through the cycle, namely, check whether they can predict changes in future default probabilities. The correspondences to the example from above are that the EDF corresponds to x, and that the rating contains information about z. For ratings, we would therefore expect a positive coefficient ($\gamma_2 = -(\rho - 1) > 0$ for $\rho<1$).

As additional explanatory variable, I include the lagged change in EDFs. Including the lagged change is a simple way of capturing time series dependencies; we would expect the rating to add something to it. Specifically, I run the following regressions of changes in EDFs on ratings, EDFs, and EDF momentum:

$$EDF_{i,t+a} - EDF_{it} = \beta_0 + \beta_1\, Rating_{it} + \beta_2 EDF_{it} + \beta_3 \left(EDF_{it} - EDF_{i,t-a}\right) + u_{it} \qquad (2)$$

$$EDF_{i,t+a} - EDF_{i,t+a-1} = \beta_0 + \beta_1\, Rating_{it} + \beta_2 EDF_{it} + \beta_3 \left(EDF_{it} - EDF_{i,t-a}\right) + u_{it} \qquad (3)$$

An assumption implicit in these regressions is that the relation between the EDF trend (z_t) and ratings is linear; it is motivated by the analysis of the previous section which has found that the relation between ratings and EDF is linear. Since the variable *Rating* is positively related to the variable *EDF* and its trend, the sign of the expected coefficients is not affected.

In the first regression, the dependent variable is the cumulative EDF change over *a* months. In the second it is the one-month change which is *a* months ahead. To make the statistical inference robust, I use in (2) only non-overlapping forecast horizons starting in December; forecast horizons in (3) are non-overlapping by construction. I also demean all variables by their cross-sectional means in order to reduce cross-sectional dependence[10] and to bring the forecasting test closer to the meaning of a rating. Ratings are assigned on a relative scale and meant to be stable on average (cf. Cantor, 2001). They are not intended to vary with aggregate default risk, so they should not be expected to predict the average trend in EDFs. Finally, I correct the standard errors for clustering within a given forecast horizon as well as within issuers.[11] An open question is how to deal with firms that default within the prediction

[10] If the stock market declines, for example, the EDFs will on average go up, resulting in the error terms being correlated across firms. Running the regressions without demeaning does not lead to a change of conclusions. Note that demeaning also purges the data of the effects of aggregate stock market fluctuations.

[11] Firm-specific clusters also take account of firm-specific serial correlation. The estimator is implemented using the procedure discussed and provided by Petersen (2008).

horizon. I examine the following two approaches: (i) use the EDFs recorded in the database or set it to the maximum of 20% used by Moody's KMV in case there is no EDF in the data base (ii) set the EDF to 100% in case of a default.

Table 2 shows the results for approach (i). Ratings significantly predict EDFs over up to 36 months. The positive coefficient is consistent with our example in equation (1). For answering the question of how far agencies look into the future it is important to note that this observation holds for cumulative changes as well as for one-month changes. (One might well be able to predict 36-months cumulative changes just on the basis of predicting the next 6 months.) The predictive quality seems to fade, but relatively slowly so. For the sake of brevity, I do not report results for approach (ii) because coefficients and t-statistics for the rating variable are consistently higher, strengthening the conclusions drawn from approach (i). The negative coefficient on EDFs is consistent with the analysis in equation (1) as $\gamma_1 = (\rho - 1) < 0$ for $\rho<1$. The coefficient on the twelve-month EDF difference varies with the horizon. It indicates that there is short-run momentum but long-run mean reversion in EDFs, which is consistent with the behavior of stock returns.

How do the results square with findings that rating changes can be predicted by market-based information, e.g. by a measure that is close to EDFs as in Delianedis and Geske (1999)? Moody's claims that it deliberately slows down the adjustment of ratings to new information in order to increase the stability of their ratings (cf. Cantor, 2001). This can lead to a lagged response to public information and will tend to reduce any predictive content that the ratings have, but it need not reduce the latter to zero.

Summing up, the regressions establish that ratings meet an important requirement that they should fulfill if they look through-the-cycle. The fact that their predictive ability extends over three years corroborates the interpretation. Since a cycle can cover several years, the interpretation would be questionable if we had found that the rating agency predicts EDFs only over a few months. Of course, the regressions provide an indirect test and do not formally prove that ratings actually look through the cycle. In the next section, I will use filter methods to extract trends and cycles from the EDF series. Relative to the reduced-form regression approach of this section, filtering requires assumptions on filter techniques, and also leads to a loss of observations, e.g. because short series or series ending in default cannot be filtered in a meaningful way. However, it will allow more specific tests of the agencies' ability to look through the cycle.

5 An analysis of ratings and EDF trends and cycles

5.1 Trend extraction techniques and trend properties

I use three methods for identifying a long-term EDF trend from the time series of EDFs: a simple moving average, local regression, and the Hodrick-Prescott filter (Hodrick and Prescott, 1997). My choice of techniques and parameters is meant to document robustness. I implement two Hodrick-Prescott filters that differ greatly in the intensity of smoothing; then I select a moving average (local regression) that is close to the Hodrick-Prescott trend with low (high) smoothing intensity. Hence, the results can show robustness with respect to smoothing intensity, as well as with respect to the technique used to achieve a given smoothing intensity.

Applied to a series of EDFs for issuer *i*, the Hodrick-Prescott filter splits it into a trend-component *HPTREND* and a cyclical component *HPCYCLE*:

$$EDF_{it} = HPTREND_{it} + HPCYCLE_{it} \tag{4}$$

The split is determined by minimizing (separately for each issuer *i*, which has data from t_0(i) to T(i)):

$$\sum_{t=t_0(i)}^{T(i)} (HPCYCLE_{it})^2 + \lambda \sum_{t=t_0(i)+2}^{T(i)} \left[(HPTREND_{it} - HPTREND_{i,t-1}) - (HPTREND_{i,t-1} - HPTREND_{i,t-2}) \right]^2 \tag{5}$$

where λ is a smoothing constant. In the minimization of (5), λ determines the weight deviations from the trend receive relative to variation in the trend. The larger λ is, the smoother is the estimated trend. Results are reported for two alternative choices, λ=10,000 and λ=500,000. For quarterly (monthly) macroeconomic data, a choice commonly made in the literature is λ=1600 (λ=14,400). One reason for choosing smoothing constants that are more extreme than in the literature is to demonstrate robustness. A further justification for the large value of λ=500,000 is that EDFs, driven by stock prices, are more volatile than the macroeconomic data on which the Hodrick-Prescott filter is commonly applied.[12]

Smoothing EDFs by local regression involves regressing EDFs on time separately for each issuer-month. The subset of observations that is used for a local regression extends over a bandwidth that has to be specified by the researcher. It is centered except for the end points, where uncentered subsets are used. I choose to report results for a bandwidth of eight years (96 months). For firm i with observations from $t = t_0(i),\ldots T(i)$, the smoothed value at time τ is the prediction for $t = \tau$ from the regression

$$EDF_{it} = b_0 + b_1 t + u_{it}, \qquad t = \max(\tau - 48, t_0(i)), \ldots, \min(\tau + 48, T(i)) \tag{6}$$

Finally, I report results for a centered 37-month moving average computed over months -18 to +18. In contrast to the local regression described above, the moving average is computed only if observations over the entire 37-month interval are available.

The three filter techniques are all forward-looking but differ in the way future data is used. The Hodrick-Prescott filter uses the entire series; the local regression is run over a fixed interval that is truncated at the end points; the moving average is computed over a fixed interval that is not truncated. Unreported analyses show that varying the parameters does not lead to qualitatively different or unexpected results. With the Hodrick-Prescott filter, for example, results for λ=50,000 lie between those for λ=10,000 and λ=500,000.

Several sample selection decisions are related to the identification of trends. Default is a special situation in which the normal trend and cycle is left; I thus split the time series on the occasion of default. Observations before the default month are treated as a separate series; observations after a default are discarded until the firm emerges from default. After emergence, observations are again treated as a separate series.[13] If there are missing observations, I treat stretches of data interrupted by missing observations as separate series.

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[12] Pedersen (2001) also recommends λ >100,000 for monthly data.

[13] Conclusions do not change if defaults are ignored and trends are computed over all observations of a company. I define emergence from default as an upgrade to B3 or better.

Regardless of the filter methodology, the empirical analyses of the later sections use only observations where EDFs for the prior and future 18 months are available. The Hodrick-Prescott filter and the local regression smoother can be computed for all observations including the first and the last, but the closer one is to the end of a series, the less future information is available for smoothing. This diminishes the forward-looking character of the trend estimate, which is important for the purpose of this study. Requiring 18 months of future observations is meant to ensure a forward-looking property that is sufficient in the sense that it is not easy to achieve by an analyst. Finally, I disregard series shorter than 48 months in order to reduce situations in which the filters yield implausible results because of a lack of cyclical fluctuations.[14] Numbers for the selection process are as follows: starting with 4,244 companies, split-ups due to missing observations and defaults increase the number of series by 1,907. The requirement that series length should be at least 48 months reduces the number of series to 2,643. The mean length of the series in this sample is 120 months (median 98).

To get an indication of the smoothing properties of the methods described above, I calculate for each series the variance of the trend in EDF and the variance of the EDF itself. The lower the ratio of these two variances, the more variability has been removed by the filter. As reported in Table 3 average ratios range from 32% to 50% and show that the Hodrick-Prescott trend with λ=10,000 is similar to the 37-month moving average, while the Hodrick-Prescott trend with λ=500,000 is similar to the trend obtained through local regression.[15] Table also reports R^2s from regressions of the form $x_{it} = b_0 + b_1 \bar{x}_t + u_{it}$, i.e. a variable is regressed on its cross-sectional means. The lower the R^2 from such a regression the lower the importance of systematic, marketwide components. The R^2s for ratings, EDFs and EDF trends are all below 10%; for EDF cycles they stay below 25%. This means that the data are predominantly driven

[14] Consider a Hodrick-Prescott trend computed over one sinusoidal cycle. Rather than being horizontal, it is a downward sloping line. This trend line is as smooth as a horizontal line, but the squared deviations from the sinusoid are smaller. Many short series are similar in that they contain just one peak and one trough.

[15] Standard deviations of variance ratios are high because they reach high values (>1) in some cases. The reason is that the sample selection excludes observations at the start and end of the series. Though excluded from the final analysis they are used in the computation of trends and their variability. If the variability of EDFs in the middle of the series is lower than at the start and end one can observe low EDF variability but high trend variability.

by non-systematic trends and cycles. Thus, the identification of firm-specific trends and cycles is essential to a successful through-the-cycle rating.

Figure 1 shows the time series of EDFs, ratings and the two Hodrick-Prescott trends (λ=10,000 or λ=500,000) for four firms. In the first chart, credit quality exhibits cyclical fluctuations around a slowly-moving trend. The second chart shows that an EDF trend can remain flat for years despite large fluctuations in EDFs (here between 0.25% and 3.5%). The final two charts are for two defaulting firms, Fruit of the Loom and Enron; they end in the month before default. The charts illustrate that the perfect-foresight character of the Hodrick-Prescott trend is reduced towards the end of the series (which motivates that the first and last 18 months are excluded from the later analysis).

Table 4 complements the visual analysis through correlations of EDFs, ratings and filtered EDFs; Pearson correlations (below diagonal) and Spearman rank correlations (above diagonal) exhibit very similar patterns. Panel A contains the correlation computed across all observations. Consistent with the agencies' practice of following a through-the-cycle approach, ratings display larger correlations with the filtered EDF trends than with original EDFs. The correlation becomes greater with increasing smoothing intensity. Are the differences economically significant? If one uses OLS to predict ratings with EDFs, the prediction error is in 62.3% of all cases smaller or equal to two rating notches. If the same is done with the HP-trend with λ=500,000, 69.3% of all predictions are at most two notches away from the actual rating. This difference appears to be significant.

When moving from pooled correlation to within-time correlation (Panel B), which is correlation computed after subtracting the variables' cross-sectional means, the correlation between ratings and EDF based variables increase. This is what we expect because ratings give a relative ordering and are not intended to capture aggregate fluctuations in default risk. For the same reason, correlations are generally lower if correlation is computed after subtracting the series-specific means (panel C) because this removes much of the relative differences in default risk from the data. Differences between EDFs trends become small but they continue to correlate more strongly with ratings than do EDFs.

5.2 Empirical analysis of ratings, trends and cycles

Do ratings predict trends in EDFs?

I start with the following regression based on three-month differences:

$$TREND_{i,t+3} - TREND_{it} = \beta_0 + \beta_1 (EDF_{i,t+3} - EDF_{it}) + \beta_2 (\,Rating_{i,t+3} - Rating_{it}) + u_{it} \quad (7)$$

where the dependent variable TREND is the trend in EDFs determined through one of the smoothing methods. The coefficient β_2 shows whether ratings help identify the trend in EDFs after controlling for the EDF; other control variables can and will be added. Since the dependent variable of (7) is not the future realization of some variable, the regression is not a classical forecasting analysis. However, it examines the forecasting ability of ratings because the left-hand side variable is based on forward-looking trends and hence contains information about the future. Note that I use three-month differences instead of levels to avoid possible concerns about non-stationarities[16]. Regressions using levels are available upon request; they strengthen the conclusions drawn from the analysis using differences. Six-month or twelve-month differences do not lead to qualitative changes in results.

To elucidate the nature and the value of the agency's predictive ability, it seems important to include additional control variables. Viewed from a particular date, the trend is obtained by smoothing over the past and the future. If rating agencies simply smoothed over the past, they could help explain the current state of the trend without being able to `foresee' future developments. In addition, the predictive quality of rating agencies could result from the exploitation of trends or trend reversals in the EDF series. Especially in the case of short-term trends, this could easily be replicated with a statistical model.

In an extended regression, I thus control for backward looking smoothing and short term trends or reversals. Specifically, I include rolling estimates of the trend, which use only information available at time *t* and which I denote by $TREND_t|t^-$, as well as the twelve-month

[16] Even though ratings and EDFs are bounded between 1 and 21 and 0.02% and 20%, respectively, one cannot rule out that trending behavior within the bounds affects the distribution of t-statistics.

difference in EDFs.[17] Following the procedure from section 4, I demean all regression variables by their cross-sectional means as this brings the analysis in line with the relative nature of ratings. To obtain robust standard errors, I use only non-overlapping quarterly data and allow for clustering within quarters as well as companies.

For the Hodrick-Prescott filter, Kaiser and Maravall (1999) and Meyer and Winker (2005) document the possibility of spurious cross-correlations induced by filtering. Applied to this paper, it means that finding an influence of ratings on trends after controlling for EDFs could be spurious. To take possible effects of spurious correlations into account, I use a bootstrap study to simulate critical *t*-values. The bootstrap is structured as follows:

(1) For each series *i* contained in the analysis, randomly select (with replacement) another series out of those which include the time span covered by series *i*. Replace the rating values of series *i* by the rating values of the randomly picked series *j*.

(2) Run the regression whose *t*-statistic is to be simulated and record the *t*-statistic associated with the rating variable.

(3) Repeat (1) to (2) 1,000 times.

I report the 97.5% percentile of the simulated t-statistics as the simulated critical value.

Regression results are reported in Table 5. Simulated critical *t*-statistics (5% significance) for the rating variable are close to the expected value of 1.96, indicating that the problem of spurious trend is not important in the data set here. Ratings contribute significantly to the explanation of EDF trend, even after controlling for backward-looking trends. The only exception is the extended regression based on the moving average trend, where the rating variable loses significance upon inclusion of the backward looking trend, which is here the uncentered moving average computed over the preceding 18 months. This, however, should not come as a surprise. Viewed in *t*, the change in the 37-months moving average from *t* to *t*+3 is completely determined by months *t*-18 to *t*-13 and months *t*+19 to *t*+24. The case is different with the other smoothing methods, because their change is determined by the

[17] If the trend is computed with the Hodrick-Prescott Filter, for example, $TREND_t|t^-$ is obtained by applying the Hodrick-Prescott filter (2) to observations $t_0(i),\ldots t$ instead of $t_0(i),\ldots,T(i)$.

interplay of past, current, and future observations. Therefore, changes in the backward-looking moving averages do a relatively good job of explaining the subsequent change of the centered moving averaged, and leave less room for other variables, including ratings. In Table 5, this is evident in the relatively high coefficient and *t*-statistic of the backward-looking moving average trend.

The evidence thus suggests that ratings look through the cycle as they contain information that is valuable for identifying the trend. Whether the predictive quality is economically significant is difficult to judge because there is no straightforward benchmark. The trends computed here are based on perfect foresight, so we cannot expect agencies to predict them perfectly or to a large extent. If a rating changes by three notches, e.g. from Aa2 to A2, the predicted percentage change in the EDF trend is up to 12.1% (=exp(0.038×3)-1), depending on the regression. This is not large but note that the correlation analysis from Table 4 has shown that most of the information contained in ratings is about relative ordering. When we examine three-month differences as we do here, the bulk of this information is not used.[18]

Stability of ratings, EDFs and EDF trends

One striking empirical characteristic of agency ratings is their considerable stability. On a one year time horizon, typically 80%-90% of ratings remain stable, compared to 40% to 50% for categories based on EDFs (Kealhofer, 2003) or other short-term forecasts of default probability (Carey and Hrycay, 2001). To compute stability measures for the present data I choose fixed EDF cutoffs to assign grades based on EDFs or EDF trends. They are set in line with average default rates of letter-only rating classes (cf. Hamilton, 2004). For example, EDFs larger than 0.02% (the minimum value of EDFs) and smaller or equal to 0.06% are assigned to one grade; stability of this grade is then compared to the stability of Moody's category Aa. The same ranges are used to classify EDF trends into grades.

Results are shown in Table 6. The reported stability is the number of observations which have

[18] If regressions are run on levels rather than on three-month differences, ratings therefore have a stronger impact on ratings. There, a one-standard-deviation change in ratings leads to a difference in the EDF trend of up to 60%.

grade i at the start and the end of a calendar year divided by the number of all observations which have grade i at the start of the year *and* which have EDF trends available at the end of the year or defaulted within the year. Availability of EDF trends is subject to the criteria defined in section 5.1. For ratings and EDFs, the figures correspond to the stylized facts cited above. The interesting finding is that stability of grades based on the Hodrick-Prescott trend with λ=500,000 or the local regression is close to the stability of ratings. From Table 4, these two trends have the highest correlation with ratings, suggesting that they provide a good approximation of what rating agencies have in mind when rating through the cycle. The results provide empirical support to the possibility result of Löffler (2004), who performed simulations based on plausible parameter choices for the credit quality process and concluded that the through-the-cycle approach might explain a large part of the stability of agency ratings.

Can ratings be described through stress-scenarios?

Carey and Hrycay (2001) and Löffler (2004) associate through-the-cycle ratings with a stress-scenario approach. A stress scenario is an unfavorable cyclical deviation from the long-term trend that occurs with a low probability. The probability of large cyclical deviations can be approximated based on the standard deviation of the cyclical component. The rating can therefore be described as $\text{TREND}_{it} + m \cdot \sigma(\text{CYCLE}_i)$, where TREND is an EDF trend, σ(CYCLE) is the standard deviation of CYCLE = EDF – TREND, and m is a multiplier related to the extremeness of the stress scenario. If ratings follow EDFs for firms that are already in stress, this leads to the following definition of a stress scenario measure:

$$\max\left[TREND_{it} + m\,\sigma\left(CYCLE_i\right),\, EDF_{it}\right], \quad m > 0 . \tag{8}$$

Alternatively, I neglect the move towards EDFs for firms that are in stress and examine

$$TREND_{it} + m\,\sigma\left(CYCLE_i\right), \quad m > 0 \tag{9}$$

If these two definitions provide a good description of the agencies' rating method they should have a higher correlation with ratings than the underlying trend. For m=1.64 and m=2.33, corresponding to (nominal) stress scenario probabilities of 5% and 1%, respectively, Table 7 shows that this is not clearly visible in the data. Often, correlations with ratings decrease when moving from the EDF trend to the stress scenario measures defined above. If they rise, the increase is small, especially when compared to the increase in correlation when moving from EDFs to EDF trends (cf. Table 4).

Possibly, the analysis fails to capture relevant aspects of the scenario approach. For several reasons, however, it seems plausible that the role of stress scenarios is indeed limited. First, rating agencies do not ascribe particular importance to the stress scenario concept. In recent years, Moody's has published several statements meant to clarify its rating policy (e.g. Cantor, 2001, or Fons, 2002). The analysis of stress scenarios is either not mentioned, or it is described as just one element of the rating process: "Fundamental credit analysis (…) seeks to predict the credit performance of bonds, other financial instruments, or firms across a range of plausible economic scenarios, some of which will include credit stress" (Fons, 2003, p. 5). Second, Löffler (2004, fn. 9) reports for his simulations that the key results do not depend on whether ratings are defined with or without stress scenarios. In the present data, finally, the standard deviation of cyclical components varies so little across firms that it would not strongly change rating assignments even if rating agencies put more weight on it. The standard deviation of $\sigma(\mathrm{CYCLE}_i)$ averages 0.15 across the four different filters, while the average standard deviation of the variable TREND is 1.43.

6 Summary and conclusion

Using a broad data set, I have shown that agency ratings contribute to the identification of long-term trends in market-based estimates of short-term default probabilities. The long-term trends have been identified by Hodrick-Prescott filtering, local regression or by taking centered moving averages. A significant part of this contribution is predictive in the sense that it adds information to statistical filters that are merely backward-looking. The paper thus lends empirical support to the agencies' claim that they follow a through-the-cycle rating concept, and that they have expertise in applying this concept. It also shows that the relatively large stability of ratings, which is often interpreted as an indicator of inefficient response to new information, could be due to the through-the-cycle methodology.

When assessing rating quality, an important aspect is the performance of ratings in the prediction of defaults. Prior literature has already documented that ratings provide valuable information, especially over horizons longer than one year (Altman and Rijken, 2006, Löffler, 2007). One could surmise that this is simply due to backward-looking smoothing, which could easily be reproduced through statistical models. The results of this paper indicate, however, that the informational value of ratings rests on a forward-looking ability.

While these findings support the usefulness of ratings, investors should be aware that, by construction, through-the-cycle ratings may underperform other predictors when it comes to short-term default prediction (cf. Löffler, 2004). For the same reason, the results of this paper are consistent with evidence that ratings underperform alternative measures of default risk or are slow to adjust their ratings. The short-term underperformance and the long-term information content of through-the-cycle ratings are two sides of the same coin. When assessing rating quality it is therefore essential to distinguish between the question of how well rating agencies fulfill their own objectives (e.g. looking through the cycle), and how well their objectives are aligned with those of rating users (e.g. short-term risk management vs. long-term investment).

The current discussion of rating quality focuses on the role of structured finance ratings in the subprime crisis. Being quantitative and not intended to be through the cycle, these ratings are not directly comparable to the corporate credit ratings studied in this paper. However, one aspect of the discussion is comparable. Structured finance ratings are based on unconditional default probability or expected loss. Therefore, they convey little or no information about liquidity or systematic risks, which many market participants were apparently not fully aware of. As in the case of corporate ratings, the rating concept can therefore be crucial for their usefulness. While the through-the-cycle concept has survived the intense discussion of rating quality in the aftermath of Enron, it remains to be seen whether agencies change the conceptual basis of structured finance ratings.

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Figure 1: EDFs, EDF trends (HP=Hodrick-Prescott) and ratings for four companies

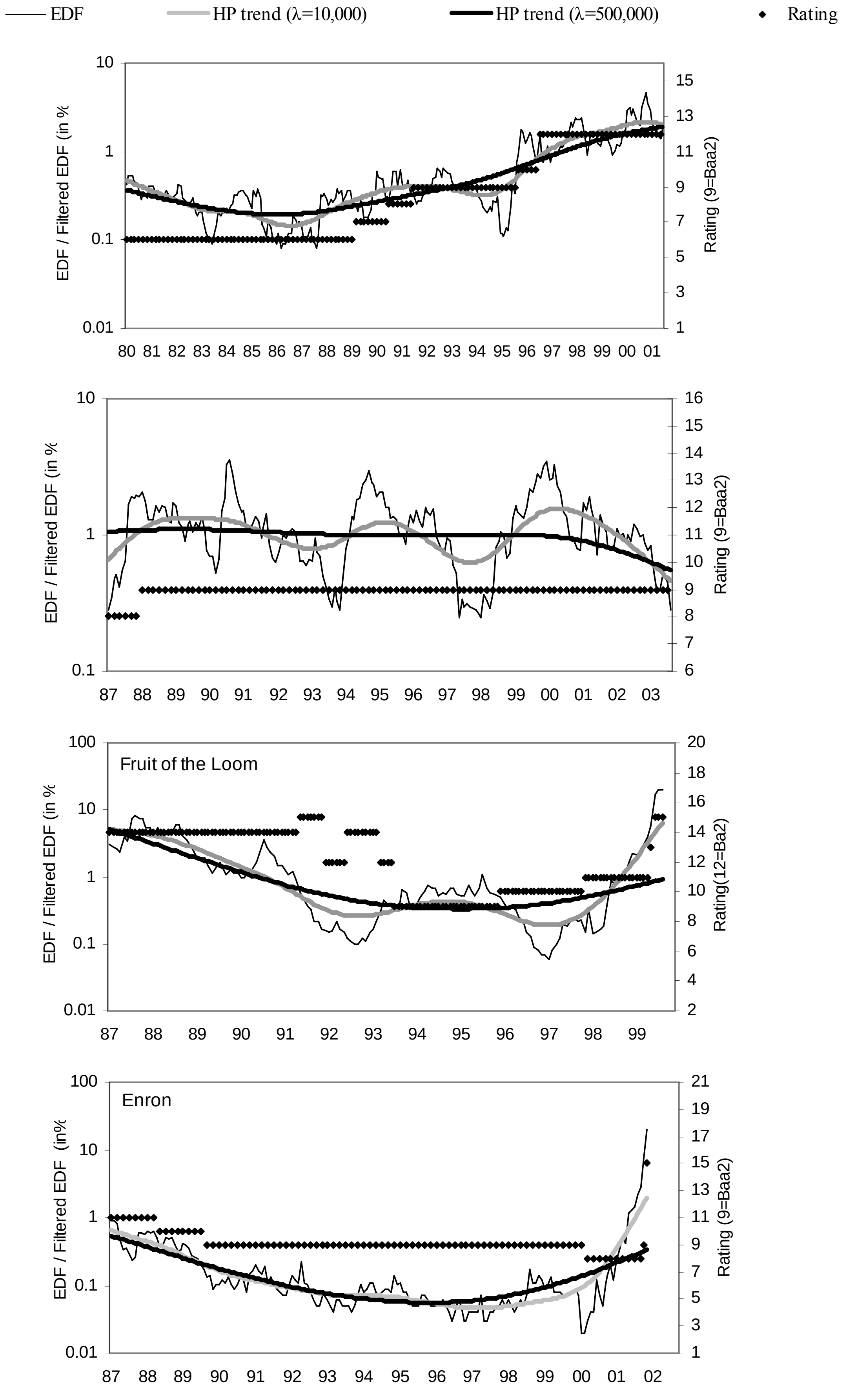

Table 1: Descriptive statistics for ratings and EDFs

Panel A: Univariate statistics					
	Mean	Median	St.dev.	Skewness	Kurtosis
EDF	2.89	-0.96	-2.21	0.28	2.62
Rating	16.01	9.39	6.00	0.13	2.27

Panel B: Adjusted R^2 from a regression of EDFs on	
	Adj. R^2
Rating	0.444
Rating, $Rating^2$, $Rating^3$, $Rating^4$, $Rating^5$	0.466
PD(Rating)	0.384

Notes: The sample includes all observations not in default. The number of observations is 356,436 firm-months. EDF is Moody's KMV expected default frequency (in logs), Rating is Moody's rating (Aaa=1, C=21), PD(Rating) is Moody's rating represented by the logarithms of idealized one-year default probabilities stated in Yoshizawa (2003).

Table 2: Do ratings predict changes in EDFs? – regressions of EDF-changes on rating and EDF information

	Prediction horizon *a*				
	6 months	12 months	18 months	24 months	36 months
Panel A: Explaining cumulative changes in EDFs ($EDF_{i,t+a} - EDF_{it}$)					
Rating	0.033	0.062	0.073	0.085	0.109
	(6.36)	(6.64)	(10.72)	(6.36)	(5.86)
EDF	-0.109	-0.208	-0.245	-0.270	-0.315
	(-7.82)	(-7.56)	(-11.95)	(-6.84)	(-6.72)
EDF_t-EDF_{t-a}	0.055	0.084	-0.005	-0.076	-0.184
	(3.65)	(3.29)	(-0.17)	(-1.40)	(-6.90)
Adj. R^2	0.040	0.072	0.079	0.104	0.154
NOB	50835	22173	12385	8000	3906
Panel B: Explaining future one-month changes in EDFs ($EDF_{i,t+a} - EDF_{i,t+a-1}$)					
Rating	0.005	0.003	0.003	0.002	0.001
	(5.90)	(9.04)	(7.31)	(4.91)	(2.03)
EDF	-0.017	-0.013	-0.011	-0.007	-0.004
	(-7.76)	(-13.27)	(-10.35)	(-6.35)	(-3.10)
EDF_t-EDF_{t-a}	0.011	-0.001	-0.005	-0.005	-0.002
	(4.45)	(-0.84)	(-4.09)	(-4.22)	(-1.52)
Adj. R^2	0.006	0.004	0.004	0.002	0.001
NOB	304655	261141	222849	190669	140035

Notes: The results are based on regressions of the form

Panel A: $$EDF_{i,t+a} - EDF_{it} = \beta_0 + \beta_1\, Rating_{it} + \beta_2\, EDF_{it} + \beta_3 \left(EDF_{it} - EDF_{i,t-a} \right) + u_{it}$$

Panel B: $$EDF_{i,t+a} - EDF_{i,t+a-1} = \beta_0 + \beta_1\, Rating_{it} + \beta_2\, EDF_{it} + \beta_3 \left(EDF_{it} - EDF_{i,t-a} \right) + u_{it}$$

where Rating is Moody's rating (Aaa=1, C=21) and EDF is Moody's KMV expected default frequency (in logs). Regression use only observations which are non-overlapping in the dependent variable. T-values (in parentheses) are corrected for heteroscedasticity and clustering within companies as well as observations belonging to the same time period [t,t+a].

Table 3: Characteristics of EDF trends used in the empirical analysis: Smoothing intensity and role of systematic components

Panel A: Variance[$TREND_i$] / variance[EDF_i]			
	Mean	Median	Standard deviation
Hodrick-Prescott trend (λ=10,000)	0.503	0.483	0.701
Hodrick-Prescott trend (λ=500,000)	0.321	0.193	0.779
Moving average trend	0.500	0.449	1.127
Local regression trend	0.323	0.192	0.803
Panel B: R^2 from pooled regression of a variable on its monthly cross-sectional means			
	R^2 for raw series	R^2 for trend	R^2 for cycle=EDF – Trend
Rating	0.018		
EDF	0.097		
Hodrick-Prescott (λ=10,000) on EDF		0.087	0.160
Hodrick-Prescott (λ=500,000) on EDF		0.041	0.219
Moving average of EDF		0.079	0.172
Local regression on EDF		0.037	0.220

Notes: The lower the variance ratios in Panel B, the higher the smoothing intensity. The lower the R^2 in Panel B, the lower the role of systematic components. EDF is Moody's KMV expected default frequency (in logs), the moving average is computed over 37 months; the local regression with an eight-year bandwidth. The number of series *i* used in Panel A is 2643, the number of observations used in Panel B is 215,326.

Table 4: Correlations between ratings, EDFs and EDF trends

	Rating	EDF	HP TREND (λ=10,000)	HP TREND (λ=500,000)	MA TREND	LR TREND
Panel A (pooled observations)						
Rating	1	0.649	0.684	0.716	0.690	0.713
EDF	0.673	1	0.965	0.908	0.958	0.893
HP TREND (λ=10,000)	0.709	0.967	1	0.963	0.999	0.949
HP TREND (λ=500,000)	0.740	0.916	0.968	1	0.970	0.998
MA TREND	0.714	0.960	0.999	0.974	1	0.957
LR TREND	0.737	0.902	0.956	0.997	0.964	1
Panel B (within-time)						
Rating	1	0.672	0.709	0.735	0.713	0.732
EDF	0.695	1	0.967	0.920	0.961	0.907
HP TREND (λ=10,000)	0.731	0.969	1	0.972	0.999	0.961
HP TREND (λ=500,000)	0.755	0.927	0.975	1	0.977	0.997
MA TREND	0.735	0.963	0.999	0.980	1	0.967
LR TREND	0.752	0.916	0.966	0.998	0.971	1
Panel C (within-series)						
Rating	1	0.205	0.231	0.237	0.231	0.231
EDF	0.279	1	0.873	0.699	0.849	0.642
HP TREND (λ=10,000)	0.311	0.891	1	0.864	0.995	0.806
HP TREND (λ=500,000)	0.318	0.730	0.880	1	0.875	0.984
MA TREND	0.310	0.871	0.996	0.892	1	0.818
LR TREND	0.311	0.682	0.835	0.989	0.848	1

Notes: Rating is Moody's rating (Aaa=1, C=21), EDF is Moody's KMV expected default frequency (in logs), HP TREND is the Hodrick-Prescott trend in EDFs with smoothing parameter λ; MA TREND denotes the centered moving average of EDFs computed over 37 months; LR TREND is obtained through local regression with an eight-year bandwidth. Entries below the diagonal are Pearson correlation coefficients, entries above are Spearman rank correlation coefficients. The number of observations is 215,326.

Table 5: Do rating changes explain changes in EDF trends?

	Dependent variable:							
	ΔHP TREND (λ=10,000)		ΔHP TREND (λ=500,000)		ΔMA TREND		ΔLR TREND	
ΔEDF_t	0.087	0.035	0.027	0.002	0.063	0.029	0.022	0.010
	(30.69)	(13.39)	(16.25)	(1.02)	(20.47)	(11.51)	(12.54)	(5.20)
$\Delta Rating_t$	0.023	0.004	0.014	0.005	0.023	0.000	0.014	0.007
	(14.68)	(5.00)	(12.51)	(8.04)	(14.62)	(-0.04)	(10.85)	(9.61)
simulated t (5%)								
$\Delta TREND_t \mid t^-$		0.215		0.193		0.387		0.076
		(20.97)		(16.21)		(31.36)		(5.84)
$EDF_t - EDF_{t-12}$		0.026		0.000		0.008		0.010
		(10.82)		(0.48)		(4.30)		(6.53)
Adj. R^2	0.14	0.49	0.05	0.27	0.08	0.46	0.03	0.13
NOB	69729	69729	69729	69729	67588	67588	69729	69729

Notes: Δ denotes 3-month differences. Rating is Moody's rating (Aaa=1, C=21), EDF is Moody's KMV expected default frequency (in logs), HP TREND is the Hodrick-Prescott trend in EDFs with smoothing parameter λ; MA TREND denotes the centered moving average of EDFs computed over 37 months; LR TREND is obtained through local regression with an eight-year bandwidth. TREND | t^- is computed with the same method as the dependent variable, but uses only information up until the current date t. Regressions use only non-overlapping observations. T-values (in parentheses) are corrected for heteroscedasticity and clustering within companies as well as within time. Simulated critical *t*-statistics for the rating variable are obtained through a bootstrap in which rating series are reshuffled across observations.

Table 6: One-year stability of ratings and EDF-based categories

Rating / EDF-Range(%)	Rating	EDF	HP TREND (λ=10,000)	HP TREND (λ=500,000)	MA TREND	LR TREND
Aa / 0.02-0.06	0.89	0.36	0.73	0.87	0.75	0.86
A / 0.06-0.12	0.92	0.32	0.51	0.75	0.53	0.73
Baa / 0.12-0.5	0.90	0.59	0.77	0.89	0.79	0.89
Ba / 0.5-2.5	0.84	0.60	0.75	0.85	0.77	0.84
B / 2.5-15	0.83	0.52	0.73	0.80	0.80	0.80

Notes: The table shows the fraction of firms whose rating grade stayed constant over one year. Rating is Moody's rating, EDF is Moody's KMV expected default frequency, HP TREND is the Hodrick-Prescott trend in EDFs with smoothing parameter λ; MA TREND denotes the centered moving average of EDFs computed over 37 months; LR TREND is obtained through local regression with an eight-year bandwidth.

Table 7: Correlations of ratings with EDF trends and stress-scenario measures of default risk

Correlation of ratings with	Trend method			
	HP (λ=10,000)	HP (λ=500,000)	MA	LR
TREND	0.709	0.740	0.714	0.737
max(TREND + 1.64 σ(CYCLE), EDF)	0.713	0.732	0.716	0.725
max(TREND + 2.33 σ(CYCLE), EDF)	0.713	0.720	0.714	0.712
TREND + 1.64 σ(CYCLE)	0.714	0.732	0.716	0.725
TREND + 2.33 σ(CYCLE)	0.713	0.744	0.718	0.741

Notes: Rating is Moody's rating (Aaa=1, C=21), EDF is Moody's KMV expected default frequency (in logs), HP denotes the Hodrick-Prescott filter with smoothing parameter λ; MA a centered moving average of EDFs computed over 37 months; LR trend is obtained through local regression with an eight-year bandwidth. CYCLE is EDF – TREND. The number of observations is 215,326.